EXHIBIT A

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K/A

Amendment No. 1

☑ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Fiscal Year Ended December 31, 2005

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Transition Period from to

Commission File Number: 0-27406

CONNETICS CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**94-3173928**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
3160 Porter Drive, Palo Alto, California	**94304**
(Address of principal executive offices)	*(Zip Code)*

Registrant's telephone number, including area code:
(650) 843-2800
Securities registered pursuant to Section 12(b) of the Act:
None
Securities registered pursuant to Section 12(g) of the Act:
Common Stock, $0.001 par value per share
Preferred Share Purchase Rights
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☐ No ☑

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.
Yes ☐ No ☑

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes ☐ No ☑

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K/A or any amendment to this Annual Report on Form 10-K/A. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.
Large Accelerated Filer ☐ Accelerated Filer ☑ Non-Accelerated Filer ☐

Table of Contents

Table of Contents

EXPLANATORY NOTE

We are amending our Annual Report on Form 10-K for the year ended December 31, 2005 ("Original 10-K") to restate our audited consolidated financial statements as of December 31, 2005 and 2004 and for each of the three years in the period ended December 31, 2005. This Annual Report on Form 10-K/A also includes the restatement of the selected financial data as of and for the each of the five years in the period ended December 31, 2005, as well as the restatement of interim results of operations for each of the two years in the period ended December 31, 2005. The restated selected financial data as of December 31, 2003, 2002 and 2001 and for the years ended December 31, 2002 and 2001 and the restated interim results of operations data are unaudited and, in the opinion of management, have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and reflect all adjustments, which are necessary for a fair presentation of results for these periods.

Revenue Reserves

As announced in our Current Report on Form 8-K filed on May 3, 2006, after we filed our Original 10-K, we concluded that our previously filed consolidated financial statements for the year ended December 31, 2005 and potentially additional periods should no longer be relied upon due to errors in the accounting for accruals of estimated rebates and chargebacks on our products. Rebates are contractual discounts offered to government programs and private health plans that are eligible for such discounts at the time prescriptions are dispensed, subject to various conditions. Chargebacks represent amounts that our wholesale customers charge us for the difference between the then-current retail price and the lower price they are paid for that product by certain government entities who are entitled to discounts under contracts with us. As part of our procedures to prepare for closing the first quarter of 2006 financial statements, during March and April 2006, we revised our accounting process for estimating revenue-related reserves, including rebates and chargebacks. In this process, we determined that our rebate and chargeback accruals had not been adequately capturing the full liability associated with product inventory in the distribution channel. We concluded that the impact of the errors we noted required us to restate our financial statements. Our revised rebate and chargeback methodology is designed to fully capture our liability for (1) incurred-but-uninvoiced rebates and unprocessed chargebacks and (2) future rebate and chargebacks associated with product inventory held in the distribution channel at period end as required by GAAP. Our revised methodology also addresses such other factors as anticipated price increases on our products and estimated future usage of our products by Medicaid programs and managed care organizations.

In the course of our evaluation of revenue reserves in prior years, management decided to apply the same resources to evaluate how we estimate accruals for returns of our products. As a result of this evaluation, we determined that our methodology for estimating future product returns contained errors and had resulted in understatements of our returns accruals. Previously, we estimated the return rate based on our cumulative historical return experience with related units shipped since initial sale and other relevant qualitative factors. For two of our products, OLUX and Luxíq, we applied the estimated return rate to the product inventory held in the distribution channel at period end, which was a smaller population than all units with potential risk of return. For our other two products, Soriatane and Evoclin, we calculated the value of the estimated units to be returned using the original sales price without taking into account price increases that were implemented between the date of sale through the period of the accrual. We permit wholesalers to return expired or expiring product for a credit at the then-current sales price less 5%, so the initial sales price may not fully capture

Table of Contents

our liability for future returns. As a result of our evaluation, we determined that our accrual for product returns had been understated and concluded that the impact of the errors required us to restate our financial statements for prior years. Our revised methodology estimates the return rate on the most recent three years' data, resulting in an estimated rate that is more responsive to current return trends. We assess the risk of return on a production lot basis and apply our estimated return rate to the units at risk for return.

We engaged external consultants to assist us in evaluating the errors made in connection with estimating accruals for rebates, chargebacks, and product returns, and in the development and implementation of our revised methodology. The effects of these adjustments on our consolidated financial statements as of December 31, 2005 and 2004 and for each of the three years in the period ended December 31, 2005 are described in Note 2 to the Consolidated Financial Statements included in this Annual Report on Form 10-K/A.

Identification of Material Weaknesses

In conjunction with the errors in accounting for accruals of estimated rebates and chargebacks and accruals for product returns, we identified two material weaknesses in internal control over financial reporting at December 31, 2005, and reported those to our Audit Committee. Please see Part II, Item 9A, "Controls and Procedures," for a description of these matters, and of certain remediation measures that we have implemented or plan to implement during 2006, as well as additional steps we are considering to strengthen our internal control over financial reporting.

Reliance on Prior Consolidated Financial Statements

Except as discussed above, we have not modified or updated disclosures presented in the Original 10-K, filed on March 13, 2006, other than as required to reflect the effects of the restatement. As such, this Annual Report on Form 10-K/A does not reflect all events that occurred after we filed our Original 10-K and does not modify or update those disclosures affected by subsequent events, except as specifically referenced in the disclosures. We have made no changes to Items in the Original 10-K other than those listed below which were affected by the restatement; therefore, we have omitted all such unchanged information.

We have not amended and do not anticipate amending our Annual Reports on Form 10-K for any of the years prior to December 31, 2005, nor will we be amending our Quarterly Reports on Form 10-Q that were originally filed. The information that has been previously filed or otherwise reported for these periods is superseded by the information in this Annual Report on Form 10-K/A. Accordingly, the consolidated financial statements and related financial information contained in those previously filed reports should no longer be relied upon.

References to this Annual Report on Form 10-K/A shall refer to the Original 10-K, as amended by this Annual Report on Form 10-K/A. The following items have been amended or added as a result of the restatement:

Part I – Item 1 – Business

Part I – Item 1A – Risk Factors

Part I – Item 1B – Unresolved Staff Comments

Part II – Item 6 – Selected Financial Data

Part II – Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations

Part II – Item 8 – Financial Statements and Supplementary Data

products. This in turn could cause a loss of our market share and negatively affect our revenues. Numerous factors could cause interruptions in the supply of our finished products, including shortages in raw material required by our manufacturers, changes in our sources for manufacturing, our failure to timely locate and obtain replacement manufacturers as needed, and conditions affecting the cost and availability of raw materials.

Orders for our products may decrease depending on the inventory levels held by our major customers. Significant changes in orders from our major customers could cause our operating results to vary significantly from quarter to quarter.

Retail availability of our products is greatly affected by the inventory levels our customers hold. We monitor wholesaler inventory of our products using a combination of methods, including information provided by the customers as well as tracking prescriptions filled at the pharmacy level to determine amounts the wholesalers have sold to their customers. Pursuant to our distribution service agreements with Cardinal, McKesson and AmerisourceBergen, we receive inventory level reports, but until December 2005 the reports we received contained inaccuracies and inconsistencies that made them unreliable. Based on reporting in December 2005, we concluded that our product inventory at those wholesalers was higher than previously estimated. For other wholesalers that do not provide us with inventory level reports, our estimates may differ significantly from actual inventory levels. Significant differences between actual and estimated inventory levels or reporting inaccuracies from the wholesalers may result in excessive inventory production, excess product available at the retail level, and unexpected increases or decreases in orders from our major customers. These changes may cause our net revenues to fluctuate significantly from quarter to quarter, and in some cases may cause our operating results for a particular quarter to be below our expectations or projections. If our financial results are below expectations for a particular period, the market price of our securities may drop significantly. See also "*Risk Factors Related to Our Business – Our decision to reduce wholesale inventory could decrease our product revenue.*"

We cannot sell our current products and product candidates if we do not obtain and maintain governmental approvals.

Pharmaceutical companies are subject to heavy regulation by a number of national, state and local agencies. Of particular importance is the FDA. The FDA has jurisdiction over all of our business and administers requirements covering testing, manufacture, safety, effectiveness, labeling, storage, record keeping, approval, advertising and promotion of our products. If we fail to comply with applicable regulatory requirements, we could be subject to fines, suspensions of regulatory approvals of products, product recalls, delays in product distribution, marketing and sale, and civil or criminal sanctions.

The process of obtaining and maintaining regulatory approvals for pharmaceutical products, and obtaining and maintaining regulatory approvals to market these products for new indications, is lengthy, expensive and uncertain. The manufacturing and marketing of drugs, including our products, are subject to continuing FDA and foreign regulatory review, and later discovery of previously unknown problems with a product, manufacturing process or facility may result in restrictions, including recall or withdrawal of the product from the market. The FDA is permitted to revisit and change its prior determinations and it may change its position with regard to the safety or effectiveness of our products. Even before any formal regulatory action, we could voluntarily decide to cease distribution and sale or recall any of our products if concerns about safety or effectiveness develop.

In its regulation of advertising, the FDA from time to time issues correspondence to pharmaceutical companies alleging that some advertising or promotional practices are false, misleading or

We also consider our claim processing lag time and the level of inventory held at wholesalers. We analyze the accrual at least quarterly and adjust the balance as needed. The inventory at retail pharmacies, which represents the rest of the distribution channel, is not considered in this accrual, as the entities eligible for chargebacks buy directly from wholesalers.

Cash Discounts

We offer cash discounts to our customers, generally 2% of the sales price, as an incentive for prompt payment. We account for cash discounts by reducing accounts receivable by the full amount of the discounts we expect our customers to take. We consider payment performance and adjust the allowance to reflect actual experience and our current expectations about future activity.

Other Adjustments

In addition to the significant gross-to-net sales adjustments described above, we periodically make other sales adjustments. For example, we may offer sales discounts to our customers and discounts and coupons to patients. Beginning in November 2005, "other adjustments" also includes payments owing to distributors pursuant to distribution services agreements. We generally account for these other gross-to-net adjustments by establishing an accrual in the amount equal to our estimate of the adjustments attributable to the sale. We generally estimate the accruals for these other gross-to-net sales adjustments primarily based on the historical experience, and other relevant factors, including levels of inventory in the distribution channel, if relevant, and adjust the accruals periodically throughout the quarter to reflect the actual experience.

Use of Information from External Sources

We use information from external sources to estimate our significant gross-to-net sales adjustments. Our estimates of inventory in the distribution channel are based on the projected prescription demand-based sales for our products and historical inventory experience, as well as our analysis of third-party information, including written and oral information obtained from certain wholesalers with respect to their inventory levels and sell-through to customers, third-party market research data, and our internal information. The inventory information received from wholesalers is a product of their record-keeping process and excludes inventory held by intermediaries to whom they sell, such as retailers and hospitals. Prior to December 31, 2005, we estimated inventory in the distribution channel using historical shipment and return information from our accounting records and data on prescriptions filled, which we purchase from Per-Se Technologies, formerly NDC Health Corporation, one of the leading providers of prescription-based information. In April 2005, we began to receive weekly reporting of inventory on hand and sales information under the distribution service agreements from our two largest customers. We identified errors in the reported information that impaired the accuracy and, as a result, usefulness of this reporting. These errors were not corrected until December 2005. In December 2005 we also began to receive weekly reporting of inventory on hand and sales information for two other customers. As a result of the improved accuracy and increased scope of our inventory reporting, we began to use the reported inventory on hand information to estimate inventory in the distribution channel as of December 31, 2005.

We use the information from Per-Se Technologies to project the prescription demand for our products. Our estimates are subject to inherent limitations pertaining to reliance on third-party information, as certain third-party information is itself in the form of estimates. In addition, our estimates reflect other limitations including lags between the date as of which third-party information is generated and the date on which we receive the third-party information.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2005

Note 1. Organization and Development of the Company

Connetics Corporation, or Connetics, was incorporated in the State of Delaware on February 8, 1993. Connetics is a specialty pharmaceutical company focusing exclusively on the treatment of dermatological conditions. We currently market four pharmaceutical products in the United States: OLUX(R) (clobetasol propionate) Foam, 0.05%, Luxíq(R) (betamethasone valerate) Foam, 0.12%, Soriatane(R) (acitretin) capsules, and Evoclin(R) (clindamycin) Foam, 1%. We acquired exclusive U.S. rights to Soriatane effective March 4, 2004 *(see Note 5)*. We also have several product candidates under development. Our commercial business is focused on the medical dermatology marketplace, which is characterized by a large patient population that is served by a relatively small number of treating physicians.

Note 2. Restatement

As announced in our Current Report on Form 8-K filed on May 3, 2006, after we filed our Annual Report on Form 10-K for the year ended December 31, 2005, filed on March 13, 2005 ("Original 10-K"), we concluded that our previously filed consolidated financial statements should no longer be relied upon due to errors in the accounting for accruals for estimated rebates and chargebacks for our products. Because we were already examining revenue reserves in prior years, management decided to apply the same resources to evaluate how we estimate accruals for returns of our products. As a result of our evaluation, we determined that our methodology for estimating future product returns had contained errors and resulted in an understatement of our returns accruals. We also recorded certain other immaterial adjustments associated with the revenue reserve adjustments. Note 2 of Notes to the Consolidated Financial Statements details the adjustments made to historical data as of December 31, 2005 and 2004 and for each of the three years in the period ended December 31, 2005.

Revenue Reserves

Rebates are contractual discounts offered to government programs and private health plans that are eligible for such discounts at the time prescriptions are dispensed, subject to various conditions. Chargebacks represent discounts that our wholesale customers charge us for the difference between the then-current retail price and the lower price they are paid by certain government entities based on contracts between us and those entities. We record provisions for rebates and chargebacks by estimating these liabilities as products are sold, based on factors such as timing and terms of plans under contract, time to process rebates, product pricing, sales volumes, amount of inventory in the distribution channel, and prescription trends. As part of our procedures to prepare for the closing of the first quarter of 2006 financial statements, during March and April 2006, we revised our accounting process for estimating revenue-related reserves, including rebates and chargebacks. As part of this process, we determined that our rebate and chargeback accruals had not been adequately capturing the full liability associated with the amount of product inventory in the distribution channel. We concluded that the impact of the revised methodology required us to restate our financial statements.

Our revised rebate and chargeback methodology is intended to fully capture our liability for (1) incurred-but-uninvoiced rebates and unprocessed chargebacks, and (2) future rebate and chargebacks associated with product inventory held in the distribution channel at period end, as required by U.S. generally accepted accounting principles. Our revised methodology also addresses factors such as

Table of Contents

anticipated price increases on our products and estimated future usage of our products by Medicaid programs and managed care organizations.

We have also determined that our prior methodology for estimating future product returns contained errors and resulted in an understatement of our returns accrual. Previously, we estimated the return rate based on our cumulative historical return experience with related units shipped since initial sale and other relevant qualitative factors. For two of our products, OLUX and Luxíq, we applied the estimated return rate to the units in the distribution channel at period end, which was a smaller population than all units with potential risk of return. For our other two products, Soriatane and Evoclin, we calculated the value of the estimated units to be returned using the original sales price without taking into account price increases that were implemented between the date of sale through the period of the accrual. We permit wholesalers to return expired or expiring product for a credit at the then-current sales price less 5%, so the initial sales price may not fully capture our liability for future returns. As a result of our evaluation, we determined that our accruals for product returns had been understated. Our revised methodology estimates the return rate on the most recent three years' data, resulting in an estimated rate that is more responsive to current return trends. We assess the risk of return on a production lot basis and apply our estimated return rate to the units at risk for return.

Immaterial Adjustments

In addition, because we have restated for these items, we have recorded certain immaterial adjustments as of December 31, 2005 and 2004 and for each of the three years in the period ended December 31, 2005.

The following tables reconcile our balance sheet and results of operations from the previously reported consolidated financial statements to the restated consolidated financial statements. Additionally, set forth below for each of the tables is an explanation of the restatement adjustments. The table below sets forth the effect of the adjustments on the Consolidated Balance Sheet as of December 31, 2005 *(in thousands):*

	December 31, 2005			
	As Previously Reported	Revenue Reserve Adjustments	Other Adjustments	As Restated
Accounts receivable, net of cash discounts and allowances of $530 (a)	$ 11,100	$ —	$ —	$ 11,100
Other current assets	301,452	—	67	301,519
Long-term assets	144,870	—	—	144,870
Total assets	457,422	—	67	457,489
Product-related accruals (a), (b), (c)	24,281	11,090	—	35,371
Other current liabilities (c)	31,851	—	(167)	31,684
Long-term liabilities	290,517	—	—	290,517
Total liabilities	346,649	11,090	(167)	357,572
Accumulated deficit	(77,215)	(11,090)	225	(88,080)
Other stockholders' equity	187,988	—	9	187,997
Total stockholders' equity	110,773	(11,090)	234	99,917
Total liabilities and stockholders' equity	$ 457,422	$ —	$ 67	$457,489

(a) Accruals for product returns and chargebacks were previously netted against accounts receivable and have been reclassified to product-related accruals.

Table of Contents

(b) Product-related accruals — The adjustment of $11.1 million represents $7.4 million related to an increase in our rebates and chargebacks reserve and $3.7 million related to an increase in our returns reserve.

(c) Accruals for payments due to wholesalers under distribution service agreements that were previously included as other accrued liabilities have been reclassified to product-related accruals.

The table below sets forth the effect of the adjustments on the Consolidated Statement of Operations for the year ended December 31, 2005 *(in thousands, except per share amounts)*:

	Year Ended December 31, 2005			
	As Previously Reported	Revenue Reserve Adjustments	Other Adjustments	As Restated
Net revenues:				
Product (a)	$ 183,312	$ (7,895)	$ —	$175,417
Royalty and contract	952	—	—	952
Total net revenues	184,264	(7,895)	—	176,369
Operating costs and expenses	160,367	—	4	160,371
Income (loss) from operations	23,897	(7,895)	(4)	15,998
Interest and other income (expense), net	201	—	—	201
Income (loss) before income taxes	24,098	(7,895)	(4)	16,199
Income tax provision (benefit) (b)	(9,860)	—	(62)	(9,922)
Net income (loss)	$ 33,958	$ (7,895)	$ 58	$ 26,121
Net income (loss) per share:				
Basic	$ 0.97			$ 0.75
Diluted	$ 0.89			$ 0.70
Shares used to compute basic and diluted net income (loss) per share:				
Basic	35,039			35,039
Diluted	41,335			41,335

(a) Net product revenues — The adjustment of $7.9 million represents an increase in our revenue reserves of $7.0 million related to an increase in our rebates and chargebacks reserve and $931,000 related to an increase in our returns reserve.

(b) Income tax provision (benefit) — The adjustment of $62,000 represents the tax effect of the other adjustments.

Table of Contents

The tables below set forth the effect of the adjustments for the four quarters in the year ended December 31, 2005:

	Three Months Ended March 31, 2005 (unaudited)			Three Months Ended June 30, 2005 (unaudited)		
	As Previously Reported	Revenue Reserve Adjustments (a)	As Restated	As Previously Reported	Revenue Reserve Adjustments (b)	As Restated
Net product revenues:						
Soriatane	$ 17,581	$ (1,217)	$16,364	$ 18,334	$ (591)	$17,743
OLUX Foam	15,792	(808)	14,984	14,033	380	14,413
Evoclin Foam	3,067	(27)	3,040	7,037	(79)	6,958
Luxíq Foam	5,654	67	5,721	5,835	389	6,224
Other	96	—	96	—	—	—
Total net product revenues	42,190	(1,985)	40,205	45,239	99	45,338
Royalty and contract revenues	181	—	181	130	—	130
Total net revenues	42,371	(1,985)	40,386	45,369	99	45,468
Operating costs and expenses	40,872	—	40,872	42,695	—	42,695
Income (loss) from operations	1,499	(1,985)	(486)	2,674	99	2,773
Interest and other income (expense), net	(353)	—	(353)	(19)	—	(19)
Income (loss) before income taxes	1,146	(1,985)	(839)	2,655	99	2,754
Income tax provision (benefit)	105	—	105	153	—	153
Net income (loss)	$ 1,041	$ (1,985)	$ (944)	$ 2,502	$ 99	$ 2,601
Net income (loss) per share:						
Basic	$ 0.03		$ (0.03)	$ 0.07		$ 0.07
Diluted	$ 0.03		$ (0.03)	$ 0.07		$ 0.07
Shares used to compute basic and diluted net income (loss) per share:						
Basic	35,699		35,699	34,825		34,825
Diluted	38,014		35,699	37,093		37,093

(a) The revenue reserves adjustment for the period ended March 31, 2005 includes $665,000 for rebate and chargeback adjustments and $1.3 million for returns.

(b) The revenue reserves adjustment for the period ended June 30, 2005 includes a decrease of $200,000 for rebate and chargeback adjustments partially offset by an increase of $101,000 for returns.

Table of Contents

	Three Months Ended September 30, 2005 (unaudited)			Three Months Ended December 31, 2005 (unaudited)			
	As Previously Reported	Revenue Reserve Adjustments (a)	As Restated	As Previously Reported	Revenue Reserve Adjustments (b)	Other Adjustments (c)	As Restated
Net product revenues:							
Soriatane	$ 23,077	$ (2,273)	$20,804	$ 13,603	$ 1,350	$ —	$ 14,953
OLUX Foam	17,323	(1,444)	15,879	14,646	(1,913)	—	12,733
Evoclin Foam	7,724	(205)	7,519	6,851	415	—	7,266
Luxíq Foam	7,014	(473)	6,541	5,599	(1,466)	—	4,133
Other	45	—	45	1	—	—	1
Total net product revenues	55,183	(4,395)	50,788	40,700	(1,614)		39,086
Royalty and contract revenues	158	—	158	483	—	—	483
Total net revenues	55,341	(4,395)	50,946	41,183	(1,614)	—	39,569
Operating costs and expenses	39,666	—	39,666	37,134	—	4	37,138
Income (loss) from operations	15,675	(4,395)	11,280	4,049	(1,614)	(4)	2,431
Interest and other income (expense), net	160	—	160	413	—	—	413
Income (loss) before income taxes	15,835	(4,395)	11,440	4,462	(1,614)	(4)	2,844
Income tax provision (benefit)	470	—	470	(10,588)	—	(62)	(10,650)
Net income (loss)	$ 15,365	$ (4,395)	$10,970	$ 15,050	$ (1,614)	$ 58	$ 13,494
Net income (loss) per share:							
Basic	$ 0.44		$ 0.31	$ 0.44			$ 0.39
Diluted	$ 0.39		$ 0.29	$ 0.40			$ 0.36
Shares used to compute basic and diluted net income (loss) per share:							
Basic	35,075		35,075	34,570			34,570
Diluted	40,812		40,812	39,735			39,735

(a) The revenue reserves adjustment for the period ended September 30, 2005 includes $3.9 million for rebate and chargeback adjustments and $496,000 for returns.

(b) The revenue reserves adjustment for the period ended December 31, 2005 includes $2.6 million for rebate and chargeback adjustments, partially offset by a decrease of $986,000 for returns.

(c) Income tax provision (benefit) – The adjustment of $62,000 represents the tax effect of the adjustments.

The table below sets forth the effect of the adjustments on the balance sheet as of December 31, 2004:

	December 31, 2004			
	As Previously Reported	Revenue Reserve Adjustments	Other Adjustments	As Restated
Accounts receivable, net of cash discounts and allowances of $708 (a)	$ 28,191	$ —	$ —	$ 28,191
Other current assets	87,927	—	20	87,947
Long-term assets	147,159	—	—	147,159
Total assets	263,277	—	20	263,297

Product-related accruals (a) (b) (c)	18,426	3,195	—	21,621
Other current liabilities (c)	26,511	—	(147)	26,364
Long-term liabilities	90,420	—	—	90,420
Total liabilities	135,357	3,195	(147)	138,405
Accumulated deficit	(111,173)	(3,195)	167	(114,201)
Other stockholders' equity	239,093	—	—	239,093
Total stockholders' equity	127,920	(3,195)	167	124,892
Total liabilities and stockholders' equity	$ 263,277	$ —	$ 20	$ 263,297

(a) Accruals for product returns and chargebacks were previously netted against accounts receivable and have been reclassified to product-related accruals.

(b) Product-related accruals — the adjustment of $3.2 million represents $471,000 million related to an increase in our rebates and chargebacks reserves and $2.7 million related to an increase in our returns reserve.

(c) Accruals for payments due to wholesalers under distribution service agreements that were previously included as other accrued liabilities have been reclassified to product-related accruals.

The table below sets forth the effect of the adjustments on the Consolidated Statement of Operations for the year ended December 31, 2004:

	Year Ended December 31, 2004			
	As Previously Reported	Revenue Reserve Adjustments	Other Adjustments	As Restated
Net revenues:				
Product (a)	$ 142,059	$ (1,137)	$ —	$140,922
Royalty and contract	2,296	—	—	2,296
Total net revenues	144,355	(1,137)	—	143,218
Operating costs and expenses	122,372	—	(33)	122,339
Income (loss) from operations	21,983	(1,137)	33	20,879
Interest and other income (expense), net	(1,475)	—	—	(1,475)
Income (loss) before income taxes	20,508	(1,137)	33	19,404
Income tax provision (benefit) (b)	1,493	—	(24)	1,469
Net income (loss)	$ 19,015	$ (1,137)	$ 57	$ 17,935
Net income (loss) per share:				
Basic	$ 0.54			$ 0.51
Diluted	$ 0.51			$ 0.48
Shares used to compute basic and diluted net income (loss) per share:				
Basic	35,036			35,036
Diluted	37,443			37,443

(a) Net product revenues — The adjustment of $1.1 million represents an increase in our revenue reserves of $221,000 related to an increase in our rebates and chargebacks reserve and $916,000 related to an increase in our returns reserve.

(b) Income tax provision (benefit) – The adjustment of $24,000 represents the tax effect of the adjustments.

Table of Contents

The tables below set forth the effect of the adjustments for the four quarters in the year ended December 31, 2004:

	Three Months Ended March 31, 2004 (unaudited)			Three Months Ended June 30, 2004 (unaudited)		
	As Previously Reported	Revenue Reserve Adjustments (a)	As Restated	As Previously Reported	Revenue Reserve Adjustments (b)	As Restated
Net product revenues:						
Soriatane	$ 3,640	$ (8)	$ 3,632	$ 17,154	$ (136)	$17,018
OLUX Foam	14,370	(397)	13,973	15,223	86	15,309
Luxíq Foam	5,471	(18)	5,453	5,614	447	6,061
Other	85	—	85	8	—	8
Total net product revenues	23,566	(423)	23,143	37,999	397	38,396
Royalty and contract	1,416	—	1,416	254	—	254
Total net revenues	24,982	(423)	24,559	38,253	397	38,650
Operating costs and expenses	22,574	—	22,574	29,541	—	29,541
Income (loss) from operations	2,408	(423)	1,985	8,712	397	9,109
Interest and other income (expense), net	(292)	—	(292)	(608)	—	(608)
Income (loss) before income taxes	2,116	(423)	1,693	8,104	397	8,501
Income tax provision (benefit)	243	—	243	647	—	647
Net income (loss)	$ 1,873	$ (423)	$ 1,450	$ 7,457	$ 397	$ 7,854
Net income (loss) per share:						
Basic	$ 0.06		$ 0.04	$ 0.21		$ 0.22
Diluted	$ 0.05		$ 0.04	$ 0.19		$ 0.21
Shares used to compute basic and diluted net income (loss) per share:						
Basic	33,587		33,587	35,242		35,242
Diluted	35,887		35,887	41,627		41,627

(a) The revenue reserves adjustment for the period ended March 31, 2004 includes $203,000 for rebate and chargeback adjustments and $220,000 for returns.

(b) The revenue reserves adjustment for the period ended June 30, 2004 includes $249,000 for returns, offset by a $646,000 decrease in our rebate and chargeback liability.

Table of Contents

	Three Months Ended September 30, 2004 (unaudited)			Three Months Ended December 31, 2004 (unaudited)			
	As Previously Reported	Revenue Reserve Adjustments (a)	As Restated	As Previously Reported	Revenue Reserve Adjustments (b)	Other Adjustments	As Restated
Net product revenues:							
Soriatane	$ 14,724	$ 130	$14,854	$ 18,049	$ (91)	$ —	$17,958
OLUX Foam	15,962	(250)	15,712	16,339	(600)	—	15,739
Evoclin Foam	—	—	—	2,883	(45)	—	2,838
Luxíq Foam	6,281	(96)	6,185	6,216	(159)	—	6,057
Other	32	—	32	8	—	—	8
Total net product revenues	36,999	(216)	36,783	43,495	(895)	—	42,600
Royalty and contract revenues	345	—	345	281	—	—	281
Total net revenues	37,344	(216)	37,128	43,776	(895)		42,881
Operating costs and expenses	33,132	—	33,132	37,125	—	(33)	37,092
Income (loss) from operations	4,212	(216)	3,996	6,651	(895)	33	5,789
Interest and other income (expense), net	(373)	—	(373)	(202)	—	—	(202)
Income (loss) before income taxes	3,839	(216)	3,623	6,449	(895)	33	5,587
Income tax provision (benefit)	144	—	144	459	—	(24)	435
Net income (loss)	$ 3,695	$ (216)	$ 3,479	$ 5,990	$ (895)	$ 57	$ 5,152
Net income (loss) per share:							
Basic	$ 0.10		$ 0.10	$ 0.17			$ 0.14
Diluted	$ 0.10		$ 0.09	$ 0.16			$ 0.13
Shares used to compute basic and diluted net income (loss) per share:							
Basic	35,510		35,510	35,695			35,695
Diluted	38,064		38,064	38,172			38,172

(a) The revenue reserves adjustment for the period ended September 30, 2004 includes $197,000 for rebate and chargebacks and $19,000 for returns.

(b) The revenue reserves adjustment for the period ended December 31, 2005 includes $467,000 for rebate and chargeback adjustments and $428,000 for returns.

The table below sets forth the effect of the adjustments on the Consolidated Statement of Operations for the year ended December 31, 2003:

	Year Ended December 31, 2003			
	As Previously Reported	Revenue Reserve Adjustments	Other Adjustments	As Restated
Net revenues:				
Product (a)	$ 66,606	$ (167)	$ —	$66,439
Royalty and contract	8,725	—	—	8,725

Total net revenues	75,331	(167)		75,164
Operating costs and expenses	77,838	—	(76)	77,762
Income (loss) from operations	(2,507)	(167)	76	(2,598)
Interest and other income (expense), net	(426)	—	—	(426)
Income (loss) before income taxes	(2,933)	(167)	76	(3,024)
Income tax provision (benefit) (b)	1,167	—	(34)	1,133
Net income (loss)	$ (4,100)	$ (167)	$ 110	$ (4,157)
Net income (loss) per share:				
Basic	$ (0.13)			$ (0.13)
Diluted	$ (0.13)			$ (0.13)
Shares used to compute basic and diluted net income (loss) per share:				
Basic	31,559			31,559
Diluted	31,559			31,559

Table of Contents

(a) Net product revenues — The adjustment of $167,000 represents a decrease of $431,000 to related to our rebates and chargebacks reserve, partially offset by an increase in our returns reserves of $598,000 .

(b) Income tax provision (benefit) — The adjustment of $34,000 represents the tax effect of the adjustments.

The cumulative effect of the revenue reserve adjustments for 2002 and 2001 was a $1.9 million increase in accumulated deficit as of January 1, 2003.

Note 3. Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Connetics, as well as its subsidiaries, Connetics Holdings Pty Ltd. and Connetics Australia Pty Ltd. We have eliminated all intercompany accounts and transactions in consolidation. We reclassified certain amounts in our prior year consolidated balance sheets, consolidated statements of operations and consolidated statements of cash flows to conform to the current period presentation. On the consolidated balance sheets, (a) accruals for product returns and chargeback accruals that were previously netted against accounts receivable as of December 31, 2005 and 2004 have been reclassified to product-related accruals, (b) raw materials inventory balances that were previously included in prepaid expenses, other current assets and other assets as of December 31, 2004, have been reclassified to inventory, (c) managed care and Medicaid rebates, or product rebates, and coupon reserves were reclassified from accounts receivable allowance to product-related accruals for the year ended December 31, 2004 and (d) accruals for payments due to wholesalers under distribution service agreements that were previously included as other accrued liabilities as of December 31, 2005 and 2004 have been reclassified to product-related accruals. On the consolidated statements of cash flows, we reclassified activity in restricted cash from a financing activity to an investing activity for the years ended December 31, 2004 and 2003.

Use of Estimates

We have prepared our consolidated financial statements in conformity with GAAP. Such preparation requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates based upon future events.

We evaluate our estimates on an on-going basis. In particular, we regularly evaluate estimates related to recoverability of accounts receivable and inventory, intangible assets, revenue reserves, assumed liabilities related to acquired product rights, accrued liabilities for clinical trial activities, and indirect promotional expenses. We base our estimates on historical experience and on various other specific assumptions that we believe to be reasonable under the circumstances. Those estimates and assumptions form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates depending on the outcome of future events, although we believe that the estimates and assumptions upon which we rely are reasonable based upon information available to us at the time they are made. To the extent there are material differences between these estimates, judgments or assumptions and actual results, our financial statements will be affected.